Profile of the Economy

[Source: Office of Economic Policy, Office of Financial Analysis]

Real gross domestic product

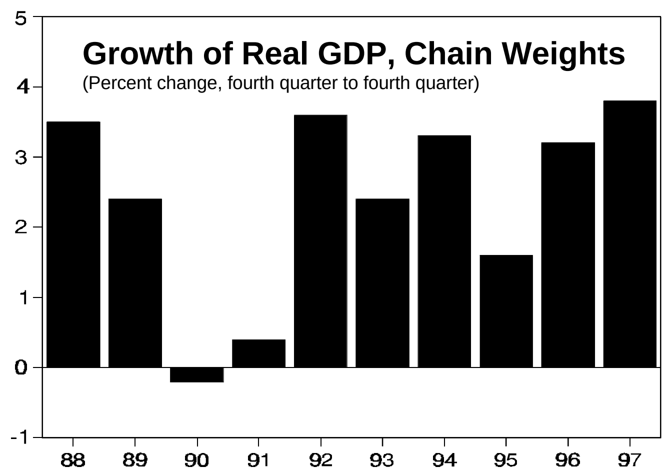
Growth in real GDP accelerated to a 3.9 percent annual rate in the fourth-quarter of 1997, capping a very strong year for the U.S. economy. Fourth-quarter growth exceeded the previous quarter's 3.1 percent pace and followed advances of 4.9 percent and 3.3 percent in the first and second quarters, respectively. The robust performance this year brought growth over the four quarters of the year to 3.8 percent, the largest such gain since 1987.

A speed up in inventory accumulation helped boost fourth-quarter growth after holding it down in the third quarter. In contrast, consumer spending slowed after posting a large 5.6 percent gain in the third quarter. The other major negative factor in the fourth quarter was a 3.5 percent decline in real business fixed investment, the first decline since 1991. Investment in equipment fell back after very strong gains of over 20 percent in each of the two previous quarters and investment in structures decreased at a 4.3 percent rate.

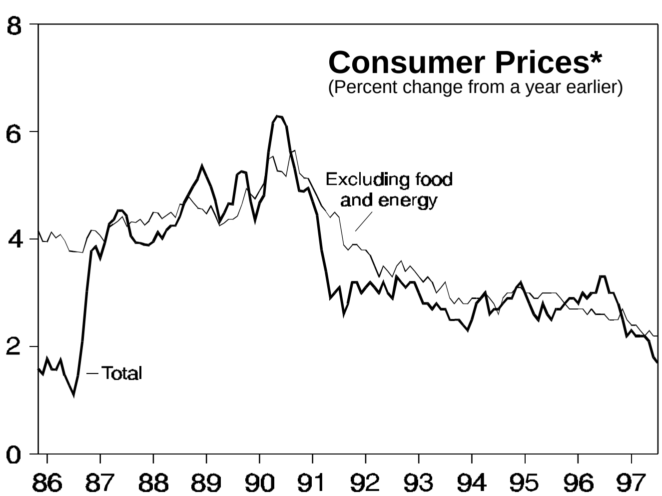
The broad measures of inflation carried in the national income accounts were very tame in the fourth quarter. The chain weighted GDP price index and the gross domestic purchases index (which subtracts exports and adds imports to get a measure of prices paid by U.S. residents) both rose at a 1.4 percent pace. Over the four quarters of 1997, the chain weighted GDP price index rose by 1.8 percent while the domestic purchases index increased by 1.4 percent, the smallest annual increases for both of these measures in more than three decades.

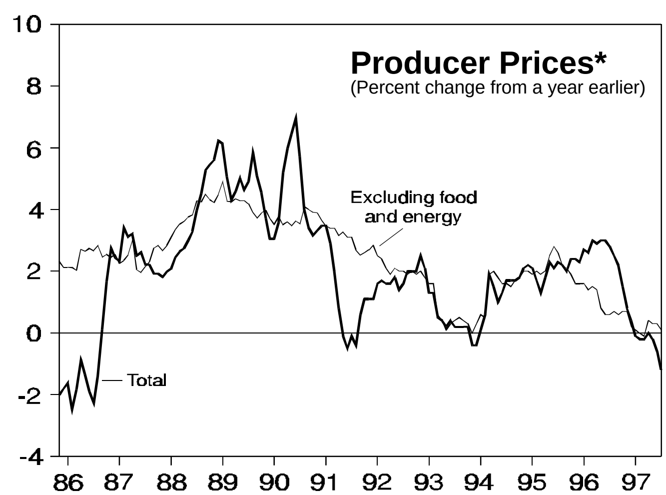
Inflation

Inflation and cost readings were very subdued in 1997. A sharp decline in energy prices and an easing in food prices were important factors in keeping inflation contained. However, even ''core'' inflation, which excludes the volatile food and energy components, was well behaved and labor costs remained low despite rising wages.



For the entire year, the consumer price index (CPI) rose by only 1.7 percent, well below the 3.3 percent advance posted in 1996. This was the smallest increase since 1986, when a steep drop in energy prices held growth in the CPI to just 1.1 percent. Much of the deceleration was due to food and energy prices, but a widespread deceleration in other consumer prices and a slowdown in the growth of medical care costs also helped restrain the index in 1997. The core CPI advanced by 2.2 percent—the smallest increase since 1965 and well below the pace of the last several years.

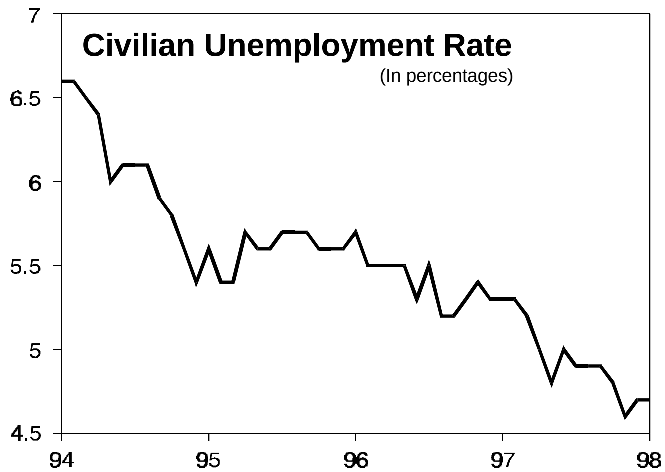


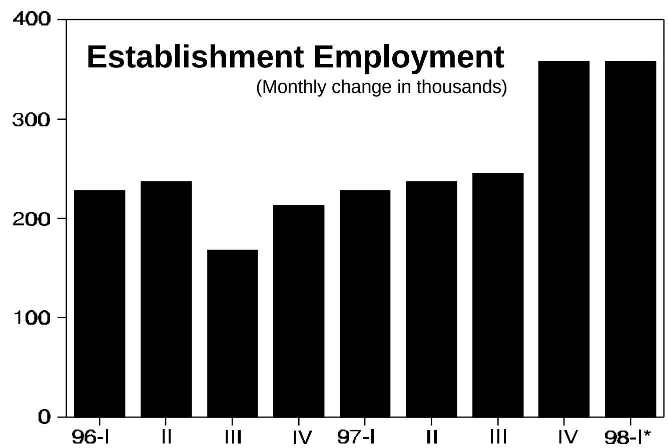


*Year tick marks correspond with June data.

Declining food and energy prices at the producer level caused finished goods prices to fall in 9 out of 12 months of 1997, and led to a retreat in the producer price index. For the year as a whole, the index was down 1.2 percent after rising 2.8 percent in 1996. On a core basis, finished goods prices rose a scant 0.1 percent, the smallest annual increase on record for this series, which began in 1974.

The cost of compensating labor, which tends to increase when labor markets are tight, remained moderate in 1997. Wages started to rise but productivity growth more than offset gains in hourly compensation, leaving unit labor costs up only 1.8 percent in 1997 compared with gains of 2 percent or more in each of the past 4 years. The employment cost index climbed 3.3 percent over the 12 months ending in December, above the 2.9 percent increase posted over the same period in 1996 and the largest advance in 4 years. An increase in wage and salary costs was offset by a slowdown in growth of benefit costs.





* Based on data for January.

Real disposable personal income and consumer spending

Real disposable (after-tax) personal income increased at a healthy 4.7 percent annual rate in the fourth quarter, the largest quarterly gain in 3 years. Growth during the entire year totaled 3.7 percent, up from 2 percent in 1996 and the highest in 5 years. Real income in 1997 was boosted by rapid growth in wages and salaries due to the expanding economy and rising wage rates. Real wages and salaries rose at a sharp 7.5 percent annual rate in the fourth quarter and by 5.5 percent over the four quarters of the year, the fastest yearly increase since 1984. (Personal income also includes such items as transfer payments, proprietors income, dividends and interest, but does not include capital gains.)

Real consumer spending slowed to a 3.2 percent annual rate increase in the final quarter of 1997 after soaring 5.6 percent in the previous quarter. A surge in motor vehicle purchases fueled much of the strong growth in third-quarter spending and this moderated in the fourth quarter. For the year, spending advanced by 3.8 percent, faster than the 2.7 percent increase recorded in 1996.

As income growth outpaced spending in the fourth quarter, the share of after-tax income devoted to personal saving rose to 3.9 percent from a very low 3.5 percent in the third quarter. The personal saving rate averaged only 3.8 percent for the year, down from 4.2 percent in 1996 and the lowest since 1939. This low rate may reflect increased net worth associated with rising stock prices, reducing the need for households to save out of current income.

Industrial production and capacity utilization

Industrial production in manufacturing, mining, and utilities was flat in January, pulled down by a sharp decline in utilities output because of unusually warm weather. Production grew 5.8 percent during the 12 months of 1997, compared with 4.7 percent during 1996 and 2.3 percent during 1995.

Manufacturing output, which accounts for about 86 percent of total industrial production, was up 0.3 percent in January, and rose at a big 6.3 percent rate last year. Manufacturing growth in 1997 was spurred by huge advances in computers and office equipment and semiconductors. Production of motor vehicles and parts also increased significantly last year.

The industrial capacity utilization rate fell to 83 percent in January from 83.3 percent in December. The utilization rate is currently about 1-1/2 percentage points below the 84.6 percent reached at the beginning of 1995, the peak for the current business cycle expansion, but it remains above its long-term average of 82.1 percent.

Employment and unemployment

Labor markets remained very strong at the start of the new year. Job growth maintained the rapid pace of the fourth quarter and the unemployment rate has held at levels not seen since 1973.

Increases in jobs on nonfarm payrolls accelerated over the course of last year, averaging 358,000 per month in the final 3 months of 1997. This was much faster than the average 237,000 pace over the first 9 months of last year and above the 212,000 per month averaged in 1996. Growth in January extended the rapid fourth-quarter pace, with payroll employment increasing by another 358,000. The January gain was widespread, including continued increases in construction and manufacturing jobs.

The unemployment rate was unchanged at 4.7 percent in January and was near its lowest in 24 years. Labor force participation has been rising and the share of the working-age population that is employed increased to a new peak of 64.2 percent in January. These indicators show that the economy continues to operate at a very high level of labor utilization.

Average hourly earnings of production and other nonsupervisory workers rose to $12.51 in January. Growth in hourly wages over the past 12 months was 3.8 percent in nominal terms. Slow growth in consumer prices last year contributed to an acceleration in growth of earnings in real terms, which rose by 2.1 percent over the year ending December 1997 compared with 0.7 percent over the year ending December 1996.

Nonfarm productivity and unit labor costs

Nonfarm business productivity (real output per hour worked) rose by 2.2 percent during the four quarters of 1997, following a 1.7 percent increase during all of 1996. These results exceeded the long-term trend growth rate of 1.1 percent per year, and they represent a marked improvement over the prior 3 years, when productivity was almost flat.

Hourly compensation costs in the nonfarm business sector rose by 4.1 percent during all of 1997. Labor costs per unit of output in the nonfarm business sector, which combine the impact of growth of compensation with that of productivity, were up at a 1.8 percent rate during the four quarters of 1997, compared to an increase of 2.2 percent during all of 1996. The 1997 rate of advance suggests that inflationary pressures remain contained.

Productivity in manufacturing grew at a 4.8 percent rate during all of 1997, after a 4.4 percent increase during 1996. Unit labor costs in manufacturing declined by 0.7 percent during 1997, following a 1.3 percent decline during 1996.

Current account balance

The current account is a summary of U.S. international transactions, measuring trade in goods and services as well as the flow of investment income on assets. On an annual basis, the current account has been in deficit since the early 1980's.

The current account deficit was roughly $40 billion in each of the first three quarters of 1997, an annual rate of $160 billion. This represents a substantial widening from a recent low of $6 billion in 1991. The faster pace of U.S. economic growth since then compared with that of our major trading partners has brought in imports at a more rapid rate than exports. In addition, what had been a positive balance on investment income shifted to negative in 1997 as the inflow of capital into the United States boosted payments of earnings and interest to foreigners.

The current account deficit so far in 1997, though large, is still $8 billion below the all-time peak deficit in 1987. The deficit relative to GDP has improved, dropping from 3.6 percent as a share of GDP in 1987 to about 2.2 percent in the first three quarters of 1997.

The widening deficit in 1997 mainly reflected the swing from surplus to deficit on investment income, primarily interest payments on the rapidly growing foreign holdings of U. S. Treasury securities. The balance on trade in goods also deteriorated in 1997 but the surplus in services improved.

Exchange rate of the dollar

The appreciation of the dollar, which began in the middle of 1995, accelerated in 1997 and continued through early 1998. Based on the Federal Reserve Board's trade-weighted index of the dollar against the currencies of other G-10 industrialized nations, the dollar rose by 11 percent over the course of 1997, more than the 4.9 percent increase recorded in 1996. In January 1998, the dollar rose a further 1.4 percent, reaching its highest mark on this basis since 1987 but holding well below the peak recorded in 1985.

Among the G-10 currencies, the dollar's appreciation has been greatest against the yen and the deutschemark, although the pattern has been erratic recently. Since the dollar's recent low in April 1995, the dollar appreciated by a total of 50 percent through the end of 1997 against the yen and by 29 percent against the deutschemark. In the first month of 1998, the dollar dipped back against the yen but appreciated slightly further against the deutschemark.

Financial crises in several newly industrialized Asian countries in 1997 led in some cases to currency devaluation, raising the dollar's value against those currencies. One result was to make imports from those countries cheaper in dollar terms, a factor that contributed to the low U.S. inflation performance last year. Another result was to raise the relative price of U.S. exports, which is expected to act as a drag on U.S. export growth in 1998.

Interest rates

Short-term market interest rates have been somewhat volatile in the fourth quarter and so far in 1998. After dipping to 4.9 percent in late September and early October, the rate on the 3-month bill moved up to 5.3 percent by the end of December. Since then it has dipped back again, to about 5.1 percent in January.

The Federal Reserve Board has not altered monetary policy since raising the Federal funds rate target by one-quarter of a point in March 1997, to 5.50 percent. The discount rate was left unchanged at 5 percent, where it has been since January 1996. At recent meetings the Board has decided to continue to leave monetary policy unchanged, partly because of the uncertainties surrounding the potential effects on the U.S. economy of the Asian financial crisis.

Long-term interest rates have been falling since last spring. The yield on the 30-year Treasury bond declined from over 7 percent in April 1997 to 5.8 percent by January. Mortgage rates have followed suit, falling from above 8 percent in April for a conventional 30-year fixed-rate loan to near 7 percent recently. These low rates have spurred a new wave of mortgage refinancings and have helped stimulate further growth in the housing market.

Net national saving and investment

Net national saving, which excludes depreciation to replace worn-out or obsolete equipment and structures used in production, rose to 7.2 percent of net national product (NNP) in the first three quarters of 1997 from 6.4 percent in 1996 and a weak 3.4 percent in 1992. Despite the progress, net saving remains well below the 12.1 percent of NNP averaged in the 1950's and 1960's.

Recent improvement is almost entirely the result of the significant narrowing of the Federal deficit, which has cut Government dissaving from a large 4.7 percent of NNP in 1992 to zero in 1997. Private saving (of households and businesses) has declined over that period, as increased wealth generated by a rising stock market appears to have reduced households' desire to save. Gains in corporate profits have led to somewhat higher business saving.

Net domestic investment equaled 8.3 percent of NNP in the three quarters of 1997. This was up from a low 4.9 percent in 1991 and was the first time since the late 1980's that domestic investment has topped 8 percent. About one-quarter of investment in 1997 was financed by foreign inflows, which were equivalent to 2.2 percent of NNP. U.S. sources provided investment equal to 6.1 percent of NNP, only about half as much as averaged in the 1950's and 1960's.

Housing

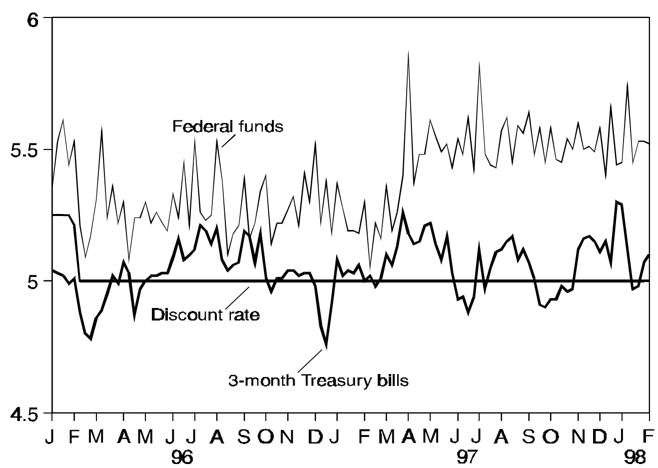
Housing activity was very strong in 1997. Robust job and income growth, high levels of consumer confidence and relatively low mortgage rates supported the housing sector throughout the year and suggest continued upward momentum in the housing market in the months ahead.

Starts of new homes totaled 1.476 million units in 1997, just slightly under the 1996 total, which was the highest since 1988. The high level of starts in 1997 was supported by the market for multi-family homes. In contrast, starts of new single-family homes were 2.4 percent lower than the previous year.

Sales of single-family homes outpaced new single-family starts, leaving the inventory of unsold new homes very tight at the end of 1997. For the year as a whole, sales of new homes climbed to 800,000 units, well above the 1996 total of 757,000 and the highest since 1978. At 4.21 million units, resales of existing homes were also very strong last year, setting a new record for this series which began in 1968.

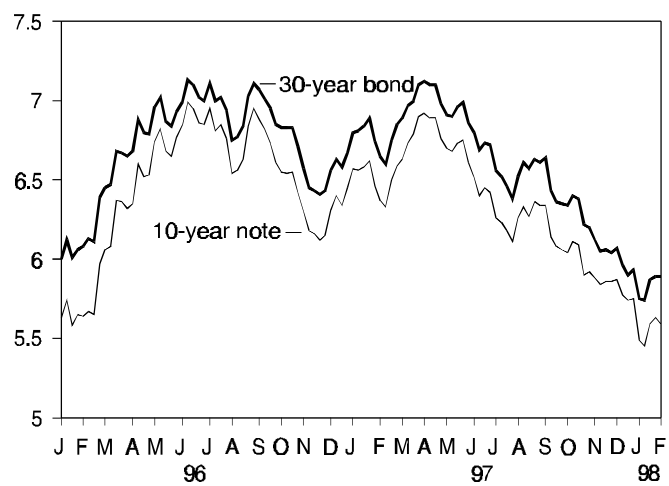
The rapid growth in home sales pushed the home ownership rate to its highest level since data were first collected in 1965, reaching 65.7 percent for the year.

Short-term Interest Rates



*Average for week ending Friday; Federal funds ending Wednesday.

Long-term Interest Rates



Federal budget

The Federal budget deficit is expected to fall to a low $10 billion in fiscal 1998 and to show a surplus of $9.5 billion in fiscal 1999. That would be the first Federal budget surplus since 1969 and only the ninth since World War II. Surpluses are projected for each year thereafter through the forecast period ending in 2003.

Strong economic growth and passage of deficit reduction programs have placed the deficit on its downward course since 1992. Since the all-time high of $290 billion in that year, the deficit fell to $22 billion in fiscal 1997.The large 1992 deficit represented 4.7 percent of GDP, while the $10 billion deficit projected for the current fiscal year would represent just 0.1 percent of GDP. Surpluses are expected to grow from the $9.5 billion projected in fiscal 1999 to about $83 billion in fiscal 2003.

Growth in receipts has been very strong over the past 4 years, boosted by expansion in jobs and income, rising corporate profits, and stock market gains. In fiscal 1997, receipts rose by 8.7 percent, with an especially notable jump for nonwithheld individual income taxes, up more than 16 percent over the year.

Growth in Federal spending was held to a moderate 2.6 percent in fiscal 1997. Slower growth in outlays was aided by large spectrum auction proceeds and asset sales in the deposit insurance account, both of which are treated as negative outlays in budget accounting. Excluding these components, outlay growth was about 4 percent in fiscal 1997, still much lower than the growth in receipts.